

**LIFE INSURANCE PLANNING**  
**EXPERT'S OPINION: PLANNING FOR LIFE INSURANCE IN QUALIFIED PLAN-DOL**  
**PERMITS SALE OF LIFE INSURANCE TRUSTS<sup>1</sup>**

**Introduction**

Andrew J. Willms, Esq. is the founding shareholder of Willms, S.C., a Wisconsin law firm. Mr. Willms practices in the areas of estate and retirement planning, probate and corporate law. Mr. Willms is a member of the State Bar of Wisconsin, the Florida Bar Association, and a faculty member of ALI-ABA estate planning courses. Mr. Willms is also a fellow of the American College of Trust and Estate Counsel.

Mr. Willms favors us with an analysis of the September 3, 2002, Department of Labor (DOL) amendment to the Prohibited Transaction Exemption (PTE) 92-6, permitting the sale of life insurance by a qualified retirement plan to a trust established by or for the benefit of the plan participant or relatives.

Mr. Willms has been a featured speaker at numerous continuing education programs for lawyers, accountants and insurance consultants, including the International Forum's Twenty-Five Million Dollar Round Table Annual Meeting, the ACLU's Annual Meeting, and frequent appearances at the Million Dollar Round Table Annual Meeting. His articles on estate and retirement planning have appeared in numerous professional journals including: *The Journal of Financial Service Professionals*, *Tax Management Estates, Trusts and Gifts Journal*, *The Practical Lawyer*, *Journal of the American Society of CLU & ChFC*, *Tax Ideas*, *The Practical Tax lawyer*, *Journal of Taxation of Investments*, *Taxation for Lawyers*, *Journal of Pension Benefits*, *Wisconsin Lawyer*, and *Successful Estate Planning Ideas and Methods*. Myron Kove, Esq., our Executive Editor, is the Interviewer.

**Discussion**

**Question 1: WHAT IS THE BENEFIT OF PURCHASING LIFE INSURANCE IN A QUALIFIED PLAN?**

**Willms:** Purchasing life insurance in a qualified plan has several benefits. These include the fact that the premiums are paid with tax deductible contributions from the employer. Because the employee does not have to pay premiums with after tax dollars, the employee can maximize the amount of insurance coverage using plan assets rather than his/her own funds. Only the cost of the term protection afforded by the policy must be included in income by the employee as premiums are paid. Purchasing life insurance inside a qualified plan creates the possibility of an immediate and substantial increase in the value of the death benefit paid by the plan if the insured participant dies prematurely.

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<sup>1</sup> This article is current as of 2002. Please contact Willms, S.C. for current information on this topic.

QUESTION 2: ARE THERE ANY DRAWBACKS TO THIS STRATEGY?

**Willms:** The major drawback is that if the plan retains the life insurance until the insured's death, then the entire death benefit will be included in the participant's gross estate for federal estate tax purposes. However, the death benefit excess of the policy's cash value (the amount at risk) is not subject to income taxation when received by the beneficiary. Code Sec. 101(a); Reg. Sec. 1.402(a)-1(a)(4); Reg. Sec. 1.72-16(c)(2)(iii). This drawback is not relevant if the participant's gross estate is less than the federal estate tax exemption or if the federal estate tax is repealed.

QUESTION 3: ARE THERE ANY POSSIBILITIES FOR AVOIDING INCLUSION OF THE INSURANCE PROCEEDS IN THE INSURED'S GROSS ESTATE FOR FEDERAL TAX PURPOSES?

**Willms:** One possibility is for the plan to distribute the life insurance policy to the insured/participant. The participant may then transfer the policy to an irrevocable life insurance trust (ILIT). Unfortunately, there are several tax traps that must be avoided to successfully use this strategy.

QUESTION 4: WHAT ARE SOME THOSE TAX TRAPS?

**Willms:** The fair market value of the policy is subject to income tax when distributed to the participant, and if he/she is under age 59 1/2, there may be an additional ten percent penalty tax. The transfer of the policy to the ILIT could trigger gift and generation-skipping taxes, and if the participant dies within three years of the transfer, then the death benefit is still included in his/her estate for estate tax purposes.

QUESTION 5: IS IT POSSIBLE TO ELIMINATE THESE TAX TRAPS WHEN THE POLICY IS DISTRIBUTED TO THE PARTICIPANT?

**Willms:** Yes. These tax traps can be eliminated if the policy is sold to the ILIT rather than distributed to the participant. When using this method, however, care must be exercised to avoid the transfer-for-value rule. Under that rule, a policy sale causes the death benefit in excess of the purchase price and subsequent premiums paid to be subject to ordinary income tax. Code Sec. 101(a)(2).

QUESTION 6: HOW IS THE TRANSFER-FOR-VALUE RULE AVOIDED?

**Willms:** There is an exception to the transfer-for-value rule if the sale is to a partner of the insured or a partnership in which the insured is a partner. Therefore, the rule can be avoided by having the insured/participant and the ILIT join together to form a partnership or a limited liability company (which for tax purposes can be treated as a partnership).

QUESTION 7: IS THERE AN ALTERNATIVE METHOD IN THE EVENT THAT ESTABLISHMENT OF A PARTNERSHIP OF LLC IS NOT FEASIBLE?

**Willms:** Another exception to the transfer-for-value rule is a transfer of the policy to the insured. Therefore, the policy could be sold to an ILIT created by the insured and structured as a grantor trust under the rules of Code Secs. 671-678. A transfer to a grantor trust is deemed to be a transfer to the insured and, therefore, is not subject to the transfer-for-value rule. Further, because a sale is involved, rather than a gift, the three year look back rule is not applicable. *Swanson*, 518 F2d 59 (CA-8 1975; Rev. Rul. 85-13; IRS Letter Rulings, 9328010, 12, 17, 19, 20, and more recently 2002200228019.)

QUESTION 8: WHAT OTHER PROBLEMS CAN RESULT WHEN A QUALIFIED PLAN SELLS AN INSURANCE POLICY?

**Willms:** Generally, qualified plans are prohibited from selling plan assets to “disqualified persons,” such as the employer/sponsor of the plan, plan participants and their family members, or a trust created for the benefit of any such person. A 15 percent penalty tax is imposed on each prohibited transaction. If the transaction is not corrected within ninety days of receiving IRS notice of the same, a second penalty of 100% of the amount involved will be imposed.

QUESTION 9: SO WILL THE SALE OF AN INSURANCE POLICY BY A QUALIFIED PLAN TO AN ILIT AUTOMATICALLY RESULT IN A PROHIBITED TRANSACTION?

**Willms:** No. The DOL has authority to issue administrative exemptions to the Prohibited Transaction rules. One of these exemptions is PTE 92-6 (57 Fed. Reg. 5189), which permits, under certain conditions, the sale of life insurance or annuity contracts by a qualified plan to the plan participant, a relative of the participant, and to the employer/sponsor. On September 3, 2002, the DOL expanded PTE 92-6, permitting the sale of life insurance by a qualified retirement plan to a trust established by or for the benefit of the plan participant or his/her family members.

QUESTION 10: WHAT CONDITIONS MUST BE MET FOR THE SALE TO NOT BE REGARDED AS A PROHIBITED TRANSACTION?

**Willms:** The conditions are (i) the contract, but for the sale, would have been surrendered by the plan; (ii) the plan receives no less than the policy’s cash value; and (iii) the sale must not, in effect, discriminate in favor of participants who are officers, shareholders or highly compensated.

QUESTION 11: DOES THIS MEAN THE SALE PRICE OF THE LIFE INSURANCE CONTRACT CAN BE SET AT ITS CASH VALUE?

**Willms:** Not necessarily. The sale of a policy by the qualified plan for less than its fair market value will result in a prohibited transaction. Therefore, cash value may be used as the sales price only if it is representative of the policy's fair market value.

QUESTION 12: HOW IS THE FAIR MARKET VALUE DETERMINED?

**Willms:** There are several possibilities. In the case of a traditional insurance contract, the cash value of the policy may very well be its fair market value. See Reg. Sec. 1.72-16(c)(2)(ii). However, if the policy is designed as a "springing cash value policy," the cash value most likely does not represent its fair market value.

QUESTION 13: WHAT ARE YOU REFERRING TO WHEN YOU MENTION A "SPRINGING CASH VALUE POLICY"?

**Willms:** With such a policy, cash values are initially less than the premium would justify and subsequently increase dramatically, often to the point where additional premiums are not required to support the contract. The purchase of a springing cash value policy by a qualified plan offers potentially significant income tax benefits if the policy is distributed to the participant or sold to an ILIT, and the cash value is used to determine the policy's value. However, it also creates serious risks.

QUESTION 14: WHAT IS THE IRS POSITION ON SPRINGING CASH VALUE POLICIES?

**Willms:** In a 1988 announcement (88-51), the IRS took the position that replacement cost or another valuation method that more nearly reflects the fair market value of the policy, rather than cash value, may have to be used to determine the fair market value of such a contract. In Notice 89-25, the IRS stated that the use of cash value was not appropriate to determine the fair market value of life insurance policies distributed from a qualified plan where the policy reserves "represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash value." These Notices are consistent with Reg. Sec. 25.2512-6, which indicates that a policy's cash value may not be used for gift tax purposes "because of the unusual nature of the contract" the cash value "is not reasonably close to the full value" of the contract.

QUESTION 15: ARE SPRINGING CASH VALUE POLICIES STILL BEING SOLD TO QUALIFIED PLANS?

**Willms:** Actuaries have worked hard to try and develop contracts that have both low cash values and low policy reserves in the early years of the contract. In response, IRS Announcement 92-182, instructed examiners to simply compare premiums paid with the cash surrender value, especially in the year of distribution in those instances where cash value is relied on to determine the fair market of a policy being transferred by a qualified

plan. If the cash value is significantly less than premiums paid and does not reflect the replacement cost of the policy, then the auditing agent is instructed to make appropriate adjustments as are necessary to the recipient's taxable income.

QUESTION 16: COULD APPLICATION OF ERISA'S PRUDENT INVESTMENT RULES ALSO RESULT IN A PROHIBITED TRANSACTION?

**Willms:** Yes. These rules prohibit plans from making an investment that is not prudent from the plan's perspective. Compliance with the requirements set forth in PTE 92-6 does not relieve the plan administrator of his/her general fiduciary responsibilities under ERISA, which, among other things, requires the fiduciary to discharge his/her duties concerning the investment of plan assets in a prudent fashion. ERISA Sec. 404(a)(1)(B). Therefore, it is important to recognize that if a plan's payment of life insurance premiums, followed by a sale of the policy for its cash value, is not prudent from the plan's perspective, the sale could violate the prudent investment rules and, therefore, result in a prohibited transaction.

QUESTION 17: WHAT IS THE EFFECT OF ALL THIS GUIDANCE?

**Willms:** The effect of the IRS guidance is that cash value should not be used to measure a policy's value at the time of distribution if (i) the cash value is significantly less than the premiums that have been paid to date, and (ii) the cost of a new policy which provides the same benefits as the distributed policy would be significantly greater than the existing policy's cash surrender value.

QUESTION 18: WHAT RISKS ARE INVOLVED IN THE EVENT OF AN AUDIT?

**Willms:** The risks of using cash surrender value as indicative of the policy's fair market value under such circumstances include (i) the risk of an IRS determination that the income taxes paid by the participant were understated, resulting in taxes due together with interest and penalties; (ii) the existence of a prohibited transaction; and (iii) the disqualification of the plan which distributed the policy.